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TEXAS SHOULD ADOPT THE UNIFORM ASSIGNMENT OF RENTS ACT: A COMPREHENSIVE STATUTE TO ELIMINATE THE TECHNICAL CONSTRUCTIONS OF STATE MORTGAGE LAW AND SECURE LENDERS' ACCESS TO PLEDGED RENTS

*Amanda L. Burcham**

INTRODUCTION

THE commercial real estate market is driven not only by the value of land and improvements, but also the income—usually rents—a building or project produces.[1] For lending institutions that finance such developments, the project "provid[es] two separate and distinct sources of security for the [debt] obligation": the property itself and the rents.[2] Mortgagees,[3] therefore, take a lien on the physical property through a mortgage, or deed of trust, as well as a separate lien on rents through an "assignment of rents and leases" (assignment of rents). The rental stream provides lenders additional security for the mortgage loan because in many jurisdictions, including Texas, a mortgagee would not otherwise be entitled to collect rents until foreclosure.[4] An assignment of rents, however, allows a mortgagee to collect and control rents when a loan obligation is in default so that the mortgagor cannot ignore his lender and collect the rents. Such pocketing of funds by mortgagors in

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1. *In re* Allen, 357 B.R. 103, 117 (Bankr. S.D. Tex. 2006) (stating the "almost universal rule" that "if an [income-producing] asset is separated from the income stream it produces, two assets may be created, and that the value of each can be separately computed. But the sum of the two values is almost always the same as the value of the asset before its income stream was separated"); GRANT S. NELSON & DALE A. WHITMAN, REAL ESTATE TRANSFER, FINANCE, & DEVELOPMENT: CASES & MATERIALS 1166 (7th ed. 2006) [hereinafter NELSON & WHITMAN, REAL ESTATE TRANSFER, FINANCE, & DEVELOPMENT].

2. 1 GRANT S. NELSON & DALE A. WHITMAN, REAL ESTATE FINANCE LAW § 4.35 (3d ed. 1993) [hereinafter NELSON & WHITMAN, REAL ESTATE FINANCE LAW].

3. This comment uses the terms "mortgage" and "deed of trust" interchangeably. In addition, "mortgagee" or "lender" describes the beneficiary under a deed of trust whereas "mortgagor" or "borrower" describes the trustor under a deed of trust.

4. FDIC v. Int'l Prop. Mgmt., 929 F.2d 1033, 1034 (5th Cir. 1991). *See infra* text accompanying notes 23–26.

arrears is commonly referred to as "milking" the rents.[5]

Security interests in rents are enforceable in every state and are regulated by state real property law rather than Article 9 of the Uniform Commercial Code (U.C.C.), which generally governs security interests in personal property.[6] Section 9-104(10) of the U.C.C. expressly "excludes from Article 9's scope any transaction intended to create a security interest in real estate."[7] Given that state property law controls, lenders and borrowers are subject to rules that vary from state to state when preparing and later enforcing their loan agreements.[8] To complicate matters, a mortgagor on arrears in his loan payments is experiencing financial trouble and is therefore more likely to file for bankruptcy.[9] In fact, bankruptcy is often seen as a refuge for debtors from creditors seeking to collect.[10] The problematic enforcement of security interests in rents is emphasized by the "massive amount of litigation" in federal bankruptcy courts on this subject and, unfortunately, such courts' inconsistent judgments.[11]

Despite the utility and thus frequent use of assignments of rents, Texas lenders face difficulties in realizing upon the pledged asset, both generally and in the context of federal bankruptcy proceedings because of their state law's technical construction of these securities. The Uniform Assignment of Rents Act ("UARA" or the "Act"), promulgated by the National Conference of Commissioners on Uniform State Laws in July 2005,[12] addresses the "'problem areas' of litigation regarding assignments of rents" and offers clarification.[13] The reporter for the new UARA, R.

5. Uniform Assignment of Rents Act (UARA) § 14 cmt. 1 (2005), *available at* http://www.nccusl.org (follow "Final Acts and Legislation" hyperlink, then choose "Assignment of Rents Act" from dropdown menu).

6. *See id.* at Prefatory Note; Butner v. United States, 440 U.S. 48, 55–57 (1979) (holding that the existence of security interest must be resolved by reference to state law even if unperfected at the time the mortgagor files bankruptcy); *In re* Vill. Props., Ltd., 723 F.2d 441, 443 (5th Cir. 1984); NELSON & WHITMAN, REAL ESTATE TRANSFER, FINANCE, & DEVELOPMENT, *supra* note 1, at 357. In addition, state law governs the effect of perfection or non-perfection as to the priority of a security interest among a debtor's common creditors. TEX. BUS. & COM. CODE ANN. § 9.301 (Vernon 2005).

7. R. Wilson Freyermuth, *Of Hotel Revenues, Rents, and Formalism in the Bankruptcy Courts: Implications for Reforming Commercial Real Estate Finance*, 40 UCLA L. REV. 1461, 1470 (1993) [hereinafter Freyermuth, *Hotel Revenues, Rents, and Formalism*].

8. UARA, Prefatory Note; R. Wilson Freyermuth, *Modernizing Security in Rents: The New Uniform Assignment of Rents Act*, 71 MO. L. REV. 1, 3 (2006) [hereinafter Freyermuth, *Modernizing Security in Rents*]; Julia P. Forrester, *A Uniform and More Rational Approach to Rents as Security for the Mortgage Loan*, 46 RUTGERS L. REV. 349, 352–55 (1993) [hereinafter Forrester, *Rational Approach*].

9. *See* UARA, Prefatory Note; *see* Forrester, *Rational Approach*, *supra* note 8, at 354–55.

10. Comment, *Mortgagee's Right to Rents after Default*, 50 YALE L.J. 1424, 1424 (1941).

11. Forrester, *Rational Approach*, *supra* note 8, at 354.

12. *See* UARA.

13. Memorandum from Edward F. Lowry, Jr., Chair, Study Comm. on Mortgagee Access to Rents from Income-Producing Land to the Comm. on Scope and Program, Nat'l Conference of Comm'rs on Unif. State Laws (July 23, 2003) (on file with Biddle Law Library, University of Pennsylvania).

Wilson Freyermuth,[14] encourages its adoption by states such as Texas "that presently lack comprehensive statutes governing security interests in rents."[15]

The purpose of this comment is to emphasize multiple sections of the UARA and offer a careful analysis of the positive changes to Texas law should Texas adopt the UARA. Part I chronicles Texas's treatment of security interests in rents, given that mortgagors retain rights to possession, use, and rents until foreclosure, unless the loan documents state otherwise. Part II discusses the divergent enforcement requirements governing the assignment of rents in Texas because, as explained in Part I, Texas courts recognize two types of assignments. Indeed, lenders in Texas face opposition as courts refuse to give effect to rental assignments. Part III then explains the difficulties federal bankruptcy courts face when determining lenders' rights to post-petition rents. Problems arise when those courts apply Texas property law in concert with Bankruptcy Code provisions which limit creditors' ability to reach a debtor's assets accruing subsequent to the filing of the bankruptcy petition. This section elucidates issues of enforcement, or "perfection," of security interests in rents. Lastly, Part IV explains the policy arguments behind the text of the new UARA, in contradistinction to Texas judicial policy, and thus the impact the Act would have on Texas law governing the assignment of rents. Overall, Texas should adopt the Act to simplify its law governing the assignment of rents. The Act would grant lenders greater flexibility by making non-judicial remedies available to realize upon pledged rentals after default, as contemplated by the average commercial real estate loan agreement.

I. CREATION OF A SECURITY INTEREST IN RENTS

A. TEXAS—A LIEN THEORY STATE

When English courts first developed the common law mortgage, a borrower conveyed in fee simple to his lender subject to the condition subsequent that title would be returned upon repayment of the debt;[16] the mortgagee received all "incidents of legal title" such as right of possession and use, right to rents, eminent domain proceeds, and, in the event of

14. For over two decades, Professor Wilson Freyermuth and others have attempted to standardize the law governing security interests in rents. *See, e.g.*, Julia P. Forrester, *Still Crazy After All These Years: The Absolute Assignment of Rents in Mortgage Loan Transactions*, 59 FLA. L. REV. (forthcoming July 2007), *available at* http://law.bepress.com/expresso/eps/1817 at 104, 104 n.12 (follow "Download the Paper" hyperlink) [hereinafter Forrester, *Still Crazy*].

15. Freyermuth, *Modernizing Security in Rents*, *supra* note 8, at 4. In addition, Professor Julia P. Forrester considers the particular "havoc" absolute assignments of rents create in commercial real estate loans; Forrester recommends that *all* state legislatures adopt the UARA because it "removes the necessity for absolute assignments of rents by creating a workable and comprehensive scheme for the creation of security interests in rents." Forrester, *Still Crazy*, *supra* note 14, at 101.

16. NELSON & WHITMAN, REAL ESTATE FINANCE LAW, *supra* note 2, § 1.2, at 6–7; Humble Oil & Ref. Co. v. Atwood, 244 S.W.2d 637, 639 (Tex. 1951).

lender's death, the land went to its devisees or heirs.[17] Over time the law changed so that a borrower retained possession but was required to collect and apply rents to the mortgage debt.[18] Similar to the English common law mortgage, American courts initially adopted the same "title" theory of mortgage law.[19] Today, only a minority of American jurisdictions have retained the title theory; the majority, instead, have adopted the "lien" theory of mortgage law.[20] At present, thirty-two states have adopted the lien theory of mortgages,[21] including Texas.[22]

Under the lien theory, a mortgagee acquires only a lien on the real property and has no right to possession, rents, or profits.[23] The mortgagor, on the other hand, retains both legal and equitable title, enjoying the rights of possession,[24] use, and rents until foreclosure.[25] Despite lien theory mortgage rules, the assignment of rents allows lenders to collect rents without necessarily foreclosing on the property, or at least allows lenders to apply rents after default, but prior to foreclosure.[26]

B. COLLATERAL AND ABSOLUTE ASSIGNMENTS OF RENTS

As suggested above, borrowers and lenders in Texas may freely contract around the operation of lien theory rules and draft an assignment of rents to give lenders rights as to rents prior to foreclosure as further security for the mortgage. In fact, Texas recognizes two distinct types of assignments of rents.[27] As a matter of public policy, Texas courts favor construing assignment of rents clauses as creating a *security interest* in rents, an inchoate lien, to serve as additional security for the mortgage

17. NELSON & WHITMAN, REAL ESTATE FINANCE LAW, *supra* note 2, § 1.2, at 6–7; *Humble Oil & Ref. Co.*, 244 S.W.2d at 639 ("Originally, possession passed by livery of seizin [sic] to the mortgagee.").

18. *Humble Oil & Ref. Co.*, 244 S.W.2d at 639 (noting that Chancery court "declared it unreasonable that [the mortgagee] should retain for his own benefit what was intended as a mere security.").

19. Memorandum from Edward F. Lowry, Jr., *supra* note 13, at pt. I.

20. *Id.*

21. NELSON & WHITMAN, REAL ESTATE TRANSFER, FINANCE, AND DEVELOPMENT, *supra* note 1, at 345 n.1. *See also* RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 4.1(a) (1997) ("A mortgage creates only a security interest in real estate and confers no right to possession of that real estate on the mortgagee.").

22. Taylor v. Brennan, 621 S.W.2d 592, 593 (Tex. 1981); *Humble Oil & Ref. Co.*, 244 S.W.2d at 640 (discussing the development of Texas mortgage law); Willis v. Moore, 59 Tex. 628, 1883 WL 9242, at *5 (Tex. 1883).

23. FDIC v. Int'l Prop. Mgmt., Inc., 929 F.2d 1033, 1034 (5th Cir. 1991) (applying Texas law); *see Taylor*, 621 S.W.2d at 593; Oryx Energy Co. v. Union Nat'l Bank of Tex., 895 S.W.2d 409, 414 (Tex. App.—San Antonio 1995, writ denied).

24. *Willis*, 1883 WL 9242, at *5. *See* NELSON & WHITMAN, REAL ESTATE FINANCE LAW, *supra* note 2, § 4.22, at 211–12.

25. *See* Forrester, *Rational Approach*, *supra* note 8, at 358–59.

26. Forrester, *Rational Approach*, *supra* note 8, at 350. Under the "title" theory—historically the majority rule—there was no need for the mortgagee to take a separate assignment of rents because the mortgagee had legal title to the real property, which included the right to collect rents. *See In re* Millette, 186 F.3d 638, 644 n.10 (5th Cir. 1999).

27. Cadle Co. v. Collin Creek Phase II Assocs., 998 S.W.2d 718, 722 (Tex. App.—Texarkana 1999, no pet.); *Oryx Energy Co.*, 895 S.W.2d at 414–15.

debt.[28] This first type is called a "collateral" assignment.[29] As will be discussed in Part II, enforcement of a collateral assignment under Texas property law requires additional measures beyond the original execution and recordation of the agreement precisely because it is an "inchoate," or *not yet activated*, interest.[30] The second and disfavored type of assignment of rents automatically and immediately conveys absolute title to rents to the mortgagee; this is called an "absolute" assignment of rents.[31] In contrast to a collateral assignment, an absolute assignment is "already 'activated' upon execution and delivery" of the document.[32] Moreover, "[a]n absolute assignment of rents is not [a] security," but rather will effectively discharge the debt by the sum total of rents collected.[33] Despite its technical form, an absolute assignment is effectually equivalent to a collateral assignment because it is typically "subject to a condition precedent that it shall become effective upon default by the mortgagor."[34] Assignment of rents clauses, therefore, are generally drafted to allow a borrower to collect rents until default, regardless of whether collateral or absolute in form. The differences between the two types, however, are of considerable consequence to the ability of a mortgagee to take collection remedies.

At present, Texas mortgage law adopts the legal fiction that the *form* of the assignment of rents clause determines whether the mortgagee's right to rents is immediately effective, regardless of the fact that, *in substance*, every assignment of rents is merely a security device.[35] Despite the "inordinately high premium [placed] upon the phraseology of the instrument,"[36] the "economic reality underlying" all assignments of rents is a mortgagee's "desire to assure payment of the debt."[37]

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28. *See* Taylor v. Brennan, 621 S.W.2d 592, 594 (Tex. 1981); Forrester, *Rational Approach*, *supra* note 8, at 363–64.

29. NCNB Tex. Nat'l Bank v. Sterling Projects, Inc., 789 S.W.2d 358, 359–60 (Tex. App.—Dallas 1990, writ dism'd w.o.j.).

30. Forrester, *Rational Approach*, *supra* note 8, at 364 (explaining that collateral assignments of rents create an inchoate security interest "until the lender has activated the assignment of rents making the security interest 'choate'").

31. *Taylor*, 621 S.W.2d at 594. *See* FDIC v. Int'l Prop. Mgmt., Inc., 929 F.2d 1033, 1035 (5th Cir. 1991). *See generally* Forrester, *Still Crazy*, *supra* note 14, at 114–120 (chronicling the historical development of the absolute assignment of rents).

32. Memorandum from Edward F. Lowry, Jr., *supra* note 13, at pt. II.B. In Texas, "[a] conveyance of an interest in real property must be in writing, signed by the grantor, and delivered to the grantee." Adams v. First Nat'l Bank of Bells/Savoy, 154 S.W.3d 859, 869 (Tex. App.—Dallas 2005, no pet. h.) (citing TEX. PROP. CODE ANN. § 5.021 (Vernon 2003)).

33. *NCNB Tex. Nat'l Bank*, 789 S.W.2d at 360 (relying on *Taylor*, 621 S.W.2d at 594).

34. *See* NELSON & WHITMAN, REAL ESTATE FINANCE LAW, *supra* note 2, § 4.35 at 245.

35. Memorandum from Edward F. Lowry, Jr., *supra* note 13, at pt. II.B. One might struggle with distinctions drawn in Texas courts because, should Article 9 of the UCC govern assignments of rents, they would be considered "transfers intended to secure a debt" regardless of form. *See Int'l Prop. Mgmt., Inc.*, 929 F.2d at 1035.

36. Comment, *Mortgagee's Right to Rents after Default*, *supra* note 10, at 1428.

37. *In re* Allen, 357 B.R. 103, 115 (Bankr. S.D. Tex. 2006) (explaining that an absolute assignment—is "based on the trust concept[ ]"—and "merely enforces the mortgagee's

1. Intent of the Parties

To determine whether an assignment of rents is collateral or absolute in form, Texas courts consider the intent of the parties rather than isolated words or phrases in the loan documents.[38] Both the assignment of rents clause and the security agreements contemporaneously executed are considered.[39] When the granting clause of an assignment of rents includes language that the instrument is given as "additional" or "further" security, Texas courts favor the interpretation that the parties intended a collateral assignment.[40] In fact, even if the loan document characterizes the assignment as "absolute," Texas courts have still found the assignment to be "collateral," holding that the mere usage of the word "absolute" is not outcome determinative.[41] For instance, the Texarkana Court of Appeals interpreted an assignment as a security (or a collateral assignment) where the agreement "absolutely and unconditionally" conveyed the rents to the mortgagee on the condition that the mortgagee enter, take possession, and collect accruing rents *after* the mortgagor's default.[42] Even though the clause purported to be a transfer of legal title, the agreement was not immediately operative because it required further action by the mortgagee, which could not be taken unless and until the loan was in default.[43]

Likewise, bankruptcy courts may refuse to give effect to "boilerplate 'absolute assignment' language" such as: "This assignment of rents constitutes an absolute assignment and not an assignment for additional security only."[44] Despite this rather clear expression, a court will look beyond such "boilerplate" to determine the actual nature of the transfer. For example, a bankruptcy court found an assignment of rents which included the above disclaimer to be "ambiguous" because an immediate transfer of rights to rents was not affected by operation of the provision.[45] In that case, the parties instead created the much-favored collateral assignment of rents.[46] The borrower and lender were co-equal beneficiaries of the rents held in trust unless and until the borrower defaults. Thus, upon default the lender "bec[ame] sole beneficiary of the rents" which oc-

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rights as a secured creditor . . . [without separating] ownership of rents from ownership of the collateral"). FDIC v. Int'l Prop. Mgmt. Inc., 929 F.2d 1033, 1036 n.3 (5th Cir. 1991).

38. Cadle Co. v. Collin Creek Phase II Assocs., 998 S.W.2d 718, 723 (Tex. App.—Texarkana 1999, no pet.) ("All of the provisions must be considered with reference to the whole instrument, and no single provision taken alone will be given controlling effect."). *See also* 801 Nolana, Inc. v. RTC Mortgage Trust 1994-S6, 944 S.W.2d 751, 754 (Tex. App.—Corpus Christi 1997, writ denied); Oryx Energy Co. v. Union Nat'l Bank of Tex., 895 S.W.2d 409, 415 (Tex. App.—San Antonio 1995, writ denied).

39. *Cadle Co.*, 998 S.W.2d at 723.

40. Taylor v. Brennan, 621 S.W.2d 592, 594 (Tex. 1981).

41. *Cadle Co.*, 998 S.W.2d at 720, 723–24.

42. *Id. See also Oryx Energy Co.*, 895 S.W.2d at 415.

43. *Oryx Energy Co.*, 895 S.W.2d at 415.

44. *In re* Allen, 357 B.R. 103, 112–13 (Bankr. S.D. Tex. 2006)

45. *Id.* at 112.

46. *Id.* at 113.

curred "*only* if [the lender] g[ave] notice of default."[47] The bankruptcy court explained that all Texas state court and Fifth Circuit Court of Appeals cases which have interpreted a rental assignment to be absolute share two things in common: "the absolute assignment of rents [was] presently effective and the assignee [was] explicitly relieved of taking any action to perfect the assignment of rents."[48] In this case, however, the borrower would lose his right to rents *only* if the lender provided it notice of default, notwithstanding the absolute assignment language.[49]

Clear evidence, therefore, is generally required before a court will find that the parties intended an immediate conveyance of legal title to rents.[50] This approach is the same as that taken by courts implying an equitable mortgage: When a transfer of absolute title to real property is, in effect, a security agreement for an existing debt, courts construe such conveyances as a mortgage.[51] Indeed, is it permissible to evaluate the nature of the assignment as further security for the mortgage, notwithstanding that the borrower purportedly transferred legal title to the rental stream? Of course, this approach of assessing the intentions of the parties is at odds with the general expectations of lenders to have access to rents upon borrowers' default, a right lenders believe the assignment guarantees.

Despite Texas courts' aversion to absolute assignments of rents, if an absolute assignment is drafted carefully, the courts will give effect to the parties' intentions. Under Texas law, an absolute assignment of rents is valid and given effect even when the assignment is "part of [a] larger secured debt agreement."[52] Take, for example, the Fifth Circuit Court of Appeals' opinion in *FDIC v. International Property Management*, holding that—despite Texas courts' reluctance to interpret an assignment of rents as absolute—the parties in the suit clearly executed a presently effective conveyance of legal title to rents, which required no affirmative action, legal proceeding, or notice to the lessees.[53]

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47. *Id.*

48. *Id.* at 112.

49. *Id.* at 112–13. More specifically, the borrower in this case agreed to use the mortgaged property as his homestead for the first year of the loan term; there would be no rents accruing, then, for at least the first year after the execution of the deed of trust containing the disputed assignment of rents clause. *Id.* at 111.

50. FDIC v. Int'l Prop. Mgmt., Inc., 929 F.2d 1033, 1036 (5th Cir. 1991).

51. Johnson v. Cherry, 726 S.W.2d 4, 6 (Tex. 1987).

52. 801 Nolana, Inc. v. RTC Mortgage Trust 1994-56, 944 S.W.2d 751, 756 (Tex. App.—Corpus Christi 1997, writ denied). *See also Int'l Prop. Mgmt., Inc.*, 929 F.2d at 1038 ("Public policy does not require us to ignore clear and unambiguous intent of the parties as expressed in their agreement.").

53. *Int'l Prop. Mgmt., Inc.*, 929 S.W.2d at 1037–38. The court in *In re Allen*, see notes 44–49 above, cites the *International Property Management* opinion as an instance where an assignment of rents clause clearly expressed the parties' intent to immediately transfer the right to rents. *See also* Lawrence J. Fossi et al., *Real Property, Part II*, 45 Sw. L. J. 2055, 2062 (1992).

2. Issues of Public Policy

While Texas courts recognize, in theory, two types of assignments of rents, they favor construing assignments as additional security for the debt and require action by the lender for activation.[54] The Texas Supreme Court cited with approval the following public policy argument crafted by the Second Circuit Court of Appeals:

> It seems unlikely that mere words of assignment of future rents can entitle a mortgagee to claim rentals which have been collected by a mortgagor and mingled with its other property. Sound policy as well as every probable intention should prevent a mortgagee from interfering with the mortgagor's possession until the mortgagee takes steps to get the rentals within his control. To hold otherwise would be to impose unworkable restrictions upon industry in cases where mortgagors have been led to suppose that they might rightfully apply the rentals to their own business.[55]

The Second Circuit emphasized that an owner-mortgagor in a commercial real estate deal, from an "industry" perspective, expects to retain control of rents without an affirmative obligation to apply his rents only to the loan debt.[56] Indeed, should a lender levy immediately upon the rents, the lender might not apply the rents to the underlying mortgage debt because loan agreements generally fail to provide an affirmative obligation to do so.[57] By embracing the Second Circuit's *Liberdar Holding* opinion, the Texas Supreme Court sent the message that, despite an assignment of rents clause, a commercial borrower expects the lender to "negotiate" a solution "informally," and to the satisfaction of both parties, should a mortgage payment become overdue.[58] If the lien on the rents is immediately effective upon default, as it would be under an absolute assignments clause, mortgagors would not be given an opportunity to retain control of rents while catching up on mortgage payments through informal negotiation. In commercial deals, business acumen likely favors a lender being slow to take control of rents the moment a borrower defaults; instead, lenders are likely to negotiate "until [they] conclude that the situation is hopeless or that continued delay may harm [them]."[59]

In contrast to *Taylor*, the better view on the basis of policy and practice is that a mortgagor in default has *less* of an incentive to apply rents to the outstanding debt, especially in Texas where foreclosure is a quick and

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54. Taylor v. Brennan, 621 S.W.2d 592, 594 (Tex. 1981) (citing Prudential Ins. Co. of Am. v. Liberdar Holding Corp., 74 F.2d 50, 51 (2d Cir. 1934)).

55. *Id.*

56. *See Liberdar Holding Corp.*, 74 F.2d at 51.

57. *See Int'l Prop. Mgmt., Inc.*, 929 S.W.2d at 1036; NELSON & WHITMAN, REAL ESTATE FINANCE LAW, *supra* note 2, § 4.35, at 247 (citing *In re* Kidd's Estate, 292 N.Y.S. 888 (1936)).

58. *See Int'l Prop. Mgmt., Inc.*, 929 S.W.2d at 1036.

59. Patrick A. Randolph, Jr., *Recognizing Lenders' Rents Interests in Bankruptcy*, 27 REAL PROP. PROB. & TR. J. 281, 290 (1992). This 1992 Randolph article is a revised and updated version of an earlier work that originally appeared at 23 U.C. DAVIS L. REV. 833 (1990) entitled *When Should Bankruptcy Courts Recognize Lenders' Rents Interests?*.

non-judicial process.[60] Moreover, in the context of a non-recourse loan, a borrower recognizes that its mortgagee may only reach the value the property itself retains, as its mortgagee cannot bring a deficiency judgment against the borrower should the foreclosure sale proceeds fail to discharge the full value of the loan. If a lender, therefore, includes an assignment of rents in a non-recourse loan agreement, it has contemplated a future ability to collect rents prior to foreclosure in order to realize upon the pledged asset. The lender takes a consensual lien on rents as a basis of the loan agreement. Such clauses do not, therefore, seem unreasonable.

II. ENFORCEMENT OF A SECURITY INTEREST IN RENTS

A. Enforcing an Assignment of Rents in Texas

1. Taylor v. Brennan *Requirements*

The most important Texas Supreme Court case concerning the interpretation and consequent enforcement of assignment of rents clauses is *Taylor v. Brennan*.[61] To date, the *Taylor* opinion resolves the enforcement of security interests in rents as it established that Texas would follow "the common law rule that [a collateral assignment of rents clause] does not become operative until the mortgagee obtains possession of the property, or impounds the rents, or secures the appointment of a receiver, or takes some other similar action."[62] Rents that accrue prior to the taking of such affirmative action will remain with the mortgagor.[63] Consider, for example, a case in which a lender only records its collateral assignment of rents and fails to take affirmative steps to enforce it. Under Texas law, when a third party creditor later gets a judgment against the borrower, the judgment creditor may file an ancillary lawsuit to garnish those rents. Because the mortgagee did not activate its inchoate lien (collateral assignment of rents), the judgment creditor will take the rents to the exclusion of the mortgagee.[64]

The *Taylor* court was silent as to the scope of its critical phrase: "other similar action." Subsequently, courts have determined what action is in the spirit of the common law rule. In cases after *Taylor*, Texas appellate courts have held that "other similar action" includes both statutory garnishment by the mortgagee and injunctions that limit or bar the mortgagor's use of its rents.[65]

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60. *See* Forrester, *Rational Approach*, *supra* note 8, at 352; Comment, *Mortgagee's Right to Rents after Default*, *supra* note 10, at 1426–27.

61. *See* Taylor v. Brennan, 621 S.W.2d 592 (Tex. 1981).

62. *Taylor*, 621 S.W.2d at 594.

63. NCNB Tex. Nat'l Bank v. Sterling Projects, Inc., 789 S.W.2d 358, 360 (Tex. App.—Dallas 1990, writ dism'd w.o.j.).

64. Forrester, *Still Crazy*, *supra* note 14, at 109 (relying on *In re* Millette, 186 F.3d 638, 642 (5th Cir. 1999)).

65. *See* Jefferson Sav. & Loan Ass'n v. Adams, 802 S.W.2d 811, 813–14 (Tex. App.—San Antonio 1990, writ denied); Betzen v. Exxon Corp., 699 S.W.2d 352, 354–55 (Tex. App.—El Paso 1985, no writ).

Properly applied, enforcement of collateral assignments of rents under *Taylor* is burdensome because either judicial action or the mortgagee taking possession of the property is required. The court's invigoration of the policy arguments above, added to the steps required to effectively enforce a collateral assignment, protect the financial interests of the mortgagor and his traditional right to possession of the mortgaged property and control of rents.

2. *What Constitutes "Rent" in Texas?*

A discussion of commercial lenders' interests in rents raises the question: what constitutes "rents" under Texas law? While gross rent profits are a type of income one usually associates with a commercial real estate project, other sources of income related to the operation and management of the property may or may not be *rents* as contemplated by Texas law. For example, Texas law defines rents in the context of the "landlord/tenant relationship and not . . . the innkeeper/lodger relationship."[66] In the ordinary landlord-tenant relationship, monies paid by an occupier under a lease to the owner-mortgagor are rents; and a lease is a possessory interest in land.[67] A license agreement, however, might produce income that is not part of the rental stream. For example, a hotel guest is a licensee under Texas law.[68] Under a license agreement, a licensee is allowed "to use land in the possession of another."[69]

Perfection of security interests in rents paid by licensees is problematic for lenders. Unlike the enforcement and perfection of assignments in rents, which are governed by Texas property law, an assignment of revenues from a parking garage would be governed by Article 9 of the U.C.C. Therefore, a lender must file a financing statement with the Texas Secretary of State to perfect a security interest in parking fees paid by licensees.[70] In a commercial real estate transaction for a building with tenants leasing space as well as renting parking, a prudent lender must both file an Article 9 financing statement as well as record an assignment of rents with the county clerk in the county in which the real property is located in order to ensure its rights to both types of revenues.[71] This process is generally a hassle because it requires more paperwork and filing fees for the lender. As will be discussed in Part III, however, if the borrower files for bankruptcy, the lender will lose its ability to collect post-petition parking fees that accrue, notwithstanding the fact that it perfected a security interest by filing a financing statement. Therefore, it would be in commercial

66. *In re* Corpus Christi Hotel Partners, Ltd., 133 B.R. 850, 854 (Bankr. S.D. Tex. 1991).

67. *See id.*

68. *Id.*; Patel v. Northfield Ins. Co., 940 F. Supp. 995, 1002 (N.D. Tex. 1996).

69. Freyermuth, *Hotel Revenues, Rents, and Formalism*, *supra* note 7, at 1467–68. *See also In re Corpus Christi*, 133 B.R. at 854.

70. *See In re Corpus Christi*, 133 B.R. at 852.

71. Filing a financing statement with the Secretary of State and recording an assignment of rents in the county land records is the "belt and suspenders" approach. *Id.*; Uniform Assignment of Rents Act (UARA) § 2 cmt. 12 (2005).

lenders' interest to have the Texas legislature broaden the definition of rents, by adopting the UARA, to include both rents paid by tenants as well as fees paid by licensees—at least in the context of revenues attachable under an assignment of rents clause.

3. Avoidance of Mortgagee-in-Possession Liability

In *Taylor*, the Texas Supreme Court held that a mortgagee may enforce a collateral assignment of rents by obtaining possession of the mortgaged property in order to collect rents.[72] In a lien theory state, however, a mortgagor has the right to possession of the mortgaged property, despite default, until foreclosure. A mortgagor in Texas must, therefore, consent before a mortgagee may take possession of the property. For this reason, loan agreements usually provide express provisions granting the lender the right to possession upon the mortgagor's default. A mortgagee-in-possession, however, is under a duty to manage the mortgaged property in a reasonably prudent and careful manner in order to keep it in a good state of repair.[73] Connected to the mortgagee's responsibility to maintain the premises is a mortgagee-in-possession's assumption of liability to third parties "for injuries resulting either through its actionable fault in utilizing the property or by reason of its failure to perform duties imposed by law upon the owner of the land."[74] Overall, the rules governing the conduct of a mortgagee-in-possession make enforcement by possession an unfavorable method.

To be sure, a good drafter will include a provision in the assignment of rents clause that expressly provides that enforcement cannot be construed as the lender becoming a mortgagee-in-possession of the property. Such a provision should discharge the lender from any obligation to collect rents, to exercise diligence in collecting rents, or to incur expenses with respect to the leases and rents. The lender, in execution and enforcement of the assignment, would accept no responsibility for the care and management of the premises. Moreover, the lender would require language discharging it from being held liable in any way for any injury or damage to person or property sustained by any person in or about the property.

4. Appointment of Receiver

Given the rigors associated with enforcement by possession, it is understandable why a lender might prefer to enforce a security interest in rents

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72. *See supra* note 56 and accompanying text. Whether the mortgagee is in possession is a question of fact that is dependent upon the "nature and condition of the property." NELSON & WHITMAN, REAL ESTATE FINANCE LAW, *supra* note 2, § 4.25, at 218. Courts look for evidence that "the mortgagee exercise[s] 'dominion and control' over the mortgaged real estate" in a similar manner as the mortgagor. *Id.*

73. Travis v. Schonwald, 131 S.W.2d 827, 829–30 (Tex. Civ. App.—Galveston 1939, writ ref'd); Bomar v. Smith, 195 S.W. 964, 980 (Tex. Civ. App.—Dallas 1917, no writ).

74. NELSON & WHITMAN, REAL ESTATE FINANCE LAW, *supra* note 2, § 4.26, at 219.

by judicial appointment of a receiver.[75] For example, collection of rents under a receivership will not subject a mortgagee to tort liability for injuries to third parties.[76] In addition, the lender avoids becoming a mortgagee-in-possession, as "the mere fact that the mortgagee receives the rents and profits does not constitute him a mortgagee in possession, unless he takes the rent in such a way as to take out of the hands of the mortgagor the management and control of the estate."[77] To properly meet filing requirements, the mortgagee in Texas would need to follow Texas Rules of Civil Procedure as well as any applicable local rules.[78] For example, a receiver's bond is required.[79]

In Texas, a lien theory state, a mortgagee's equitable right to a receiver for control of the *property* itself is not triggered by default, as a mortgagor retains rights to possession, use, and profits until foreclosure.[80] Under existing Texas statutory law, a mortgagee may not obtain appointment of a receiver unless there is a significant and material threat to the land and improvements, or the mortgagor is in default *and* the real property is inadequate security.[81]

Fortunately for lenders seeking a receiver for control and use of *rents*, they need not allege that the real property is in danger of being lost or injured.[82] The Texas Supreme Court's language in *Taylor* does not require that lenders allege the real property is insufficient to discharge the debt, as the property and rents are separate securities.[83]

It is common to see a loan agreement provision that expressly authorizes "the appointment of a receiver on default to collect rents and profits and apply them to the secured debt."[84] This receivership clause is designed to work in tandem with the assignment of rents to fully protect the mortgagees' interest in rents. Nevertheless, the recital in a deed of trust that the parties agree to the appointment of a receiver in the event of default is merely "one of the equities to be considered" and thus, is not

75. A receiver can only be appointed by a court. And, "[a]lthough a receiver represents all parties [sic] interests in the litigation wherein he is appointed, . . . generally he is the agent of the appointing court." Payne v. Snyder, 661 S.W.2d 134, 143 (Tex. Ct. App.—Amarillo 1983, writ ref'd n.r.e.). *See also* Dillingham v. Putnam, 14 S.W. 303, 305 (Tex. 1980) ("Property in the hands of a receiver is theoretically in the hands of the court that appointed him. . . .").

76. NELSON & WHITMAN, REAL ESTATE FINANCE LAW, *supra* note 2, § 4.32, at 236.

77. First Nat'l Bank in Graham v. Corbin, 153 S.W.2d 979, 982 (Tex. Civ. App.—Fort Worth 1941, writ denied).

78. *See generally* TEX. R. CIV. PROC. §§ 695, 695a. *See infra* note 179 and accompanying text.

79. TEX. R. CIV. PROC. § 695a.

80. *See* King Land & Cattle Corp. v. Fikes, 414 S.W.2d 521, 524 (Tex. Civ. App.—Fort Worth 1967, writ ref'd n.r.e.).

81. TEX. CIV. PRAC. & REM. CODE ANN. § 64.001(c) (Vernon 1997).

82. Riverside Props. v. Teachers Ins. & Annuity Ass'n of Am., 590 S.W.2d 736, 737–38 (Tex. Civ. App.—Houston [14th] 1979, no writ).

83. Jesse B. Heath, Jr., *New Developments in Real Estate Financing*, 12 ST. MARY'S L.J. 811, 826–27 (1981).

84. NELSON & WHITMAN, REAL ESTATE FINANCE LAW, *supra* note 2, § 4.35, at 242.

determinative in a Texas court's decision.[85] The reason for this is that courts have discretion to appoint a receiver in equity.[86]

Overall, judicial enforcement of an assignment of rents clause is generally burdensome, especially since foreclosures in Texas are usually nonjudicial, because lenders typically use deeds of trust.[87] A Texas foreclosure is a relatively fast process, as the mortgagee must mail a written notice a minimum of twenty-one days before the date of sale—which is the first Tuesday of each calendar month—to *only* the owner-mortgagor, in addition to the formalities of posting a public notice at the courthouse door and filing a notice in the office of the county clerk located in the same county as the property at issue.[88] Because deeds of trust require no judicial action, it is "rare" that lenders would enforce collateral assignments of rents by judicial action.[89]

5. *Waste of Rents*

Under Texas law, when a mortgagee takes affirmative steps to adequately enforce its collateral assignment of rents, a mortgagor's subsequent failure to turn over the rents or apply rents to the mortgage debt "constitutes legal waste."[90] *Taylor v. Brennan*, the seminal Texas Supreme Court case on rents assigned as security, was a suit for damages for waste of security.[91] The court recognized that a mortgagor's milking of rents may give rise to a cause of action in waste, so long as the mortgagee has taken the requisite affirmative steps to enforce its security interest in the rentals.[92] Because rents are a separate security from the underlying real property, the measure of damages is the amount of rents collected after default but not applied to the mortgage debt.[93] In a general suit for waste on the real property itself, such as when the owner-mortgagor removes improvements, a mortgagee has a colorable claim only if the value of the property, notwithstanding the damages, is insufficient security for the mortgage debt.[94] In *Taylor*, the Texas Supreme Court estab-

85. *Riverside Props.*, 590 S.W.2d at 738 (holding, nonetheless, that a reciever was appropriate). Under the Restatement, a mortgagee is entitled to a receivership "if the mortgagor is in default . . . and the mortgage or other agreement contains either [an assignment of rents clause] or a provision authorizing appointment of a receiver to take possession and collect rents upon mortgagor default." RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 4.3(b) (1997).

86. TEX. CIV. PRAC. & REM. CODE ANN. § 64.004 (Vernon 2007).

87. *See* TEX. PROP. CODE ANN. § 51.002 (Vernon 2003). Lenders foreclose under the power of sale provision in a deed of trust which, under Texas statute, occurs at a publicly held auction. *Id.*

88. *See id.* § 51.002(b)(1)–(3)

89. *In re* Vill. Props., Ltd., 723 F.2d 441, 446 n.1 (5th Cir. 1984).

90. Taylor v. Brennan, 621 S.W.2d 592, 593 (Tex. 1981). *See also* Uniform Assignment of Rents Act ("UARA") § 14 cmt. 1 (2005).

91. *Taylor*, 621 S.W.2d at 593.

92. *Id.* at 593–95.

93. Heath, *supra* note 83, at 826.

94. Frio Inv., Inc. v. 4m-IRC/Rohde, 705 S.W.2d 784, 786 (Tex. App.—San Antonio 1986, writ ref'd n.r.e.). Texas courts have pronounced that "a mortgagee is entitled to the amount of the diminution of his security, and not necessarily the amount of damage done

lished that an assignment of rents is a separate security, meaning that the lender is only required to have taken affirmative steps to collect rents, and there is no issue as to whether the property itself is adequate security.[95]

6. *Conclusion*

A sophisticated commercial lender in Texas should carefully draft *absolute* assignments of rents into its mortgage documents. In order to create an absolute assignment of rents, the lender must pretend to take title to rents; thus, the assignment of rents clause in the loan documents, albeit given as additional security for the debt, stands as an immediate transfer of legal title. Once the lender has an absolute assignment of rents, it is perfected when it is recorded. Furthermore, its absolute assignment of rents may be enforced by sending notices or as otherwise described in the agreement. A mortgagee holding an absolute assignment of rents may seek injunctive relief and receivership to prevent the mortgagor from collecting rents.[96] In truth, a mortgagee may use any remedy available to enforce a collateral assignment of rents for the enforcement of an absolute assignment of rents.[97] Within a carefully drafted absolute assignment of rents, a sophisticated lender should include language expressly discharging it from any liability to third parties, denying responsibilities as a mortgagee-in-possession, and refuting any obligation to maintain the premises.

III. "THE KNOTTY ISSUES SURROUNDING RENT ASSIGNMENTS IN BANKRUPTCY"[98]

A. Tug of War

Federal bankruptcy courts frequently handle disagreements between mortgagors and mortgagees related to the enforcement of assignments of rents, since a commercial mortgagor in default is likely to be so financially troubled that bankruptcy results.[99] As soon as the bankruptcy petition is filed, a tug of war begins between the debtor (or bankruptcy trustee) and his common creditors. While there are five kinds of bankruptcy cases, the debtor seeks relief through either liquidation or reorganization of his finances. In the context of commercial real estate—this Article's primary focus—a debtor who owns an income producing prop-

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to the property; because, where his security is still sufficient or his debt finally paid, he is not damaged." Wheeler v. Peterson, 331 S.W.2d 81, 83 (Tex. Civ. App.—Fort Worth 1960, writ dism'd).

95. Heath, *supra* note 83, at 827.

96. *See* 801 Nolana, Inc. v. RTC Trust, 944 S.W.2d 751, 756 (Tex. App.—Corpus Christi 1997, writ denied); NCNB Texas Nat'l Bank v. Sterling Projects, Inc., 789 S.W.2d 358, 360 (Tex. App.—Dallas 1990, writ dism'd w.o.j.).

97. *In re* Vill. Props. Ltd., 723 F.2d 443, 446 (5th Cir. 1984).

98. Restatement (Third) of Prop.: Mortgages § 4.2, Reporter's Note, Introductory note, cmt. a.

99. *See id.*

erty is "typically a partnership or corporate entity that has no assets other than the development" and will likely want to restructure and discharge its debts with a reorganization plan rather than a bankruptcy that liquidates all of its non-exempt assets.[100] Therefore, the profits from the property, such as rents, will be useful, if not essential, to the debtor's rehabilitation.[101] The debtor seeks to block the mortgagee from collecting rents post-petition.[102] Should the debtor succeed, the lenders' ability to enforce a lien on rents is frustrated when the bankruptcy proceeding suspends their ability to not only foreclose on the property, but also protect the value of their security at the very moment when they need the rents most: when the debtor-mortgagor is no longer making the loan payments.[103]

B. The Perfection Headache

State property law governs the enforcement and perfection of assignments of rents in the bankruptcy context.[104] As discussed above, Texas case law has established that a mortgagee's collateral assignment of rents is not operative unless and until it has taken affirmative steps to enforce its security interests.[105] The Bankruptcy Code may prevent a Texas mortgagee from enforcing its security interest in rents once the mortgagor is in bankruptcy. The debtor-mortgagor's filing a bankruptcy petition gives rise to an automatic stay of pending proceedings by creditors against the debtor's estate or enforcement of liens on the debtor's assets.[106] Of course, if the mortgagee and mortgagor executed an absolute assignment of rents, the issue of post-petition perfection is irrelevant, because the mortgagee perfected its security interest upon recordation and thus, the automatic stay would have no effect on the mortgagee's lien attaching to post-petition rents.

Until 1994, debate over the perfection of assignments of rents had been mired in varying and technical constructions of states' property law. Finally, the United States Congress amended the Bankruptcy Code in an attempt to create uniform rules for the post-petition perfection and enforcement of assignments of rents in bankruptcy proceedings. However, as the following sections explain, the Code's new language fails to fully protect lenders' access to rents.

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100. *See* Freyermuth, *Hotel Revenues, Rents and Formalism*, *supra* note 7, at 1463.

101. *Id.*

102. *Id.*

103. Randolph, *supra* note 54, at 289.

104. Butner v. United States, 440 U.S. 48, 48–49 (1979).

105. *See supra* text accompanying notes 57–60.

106. 11 U.S.C. § 362(a)(4)–(5) (2005). Section 362(a), in general, lists acts and actions that are stayed by the bankruptcy case. See 11 U.S.C.§ 362(b)–(d) for specific exceptions to the automatic stay and circumstances under which a bankruptcy court may grant a creditor relief from the stay.

1. Perfection of a Security Interest in Rents Before 1994

Lenders in commercial projects and transactions include an after-acquired property clause in the loan agreement to take a consensual lien on property the borrower acquires in the future. Section 552(a) of the Bankruptcy Code cuts off lenders' claims to property acquired after the bankruptcy petition is filed.[107] For corporate entities filing a bankruptcy petition, section 552(a) therefore, "serves an important economic function, as an after-acquired property clause" and, if allowed to remain legally effective, "would prevent the debtor from using assets acquired post-petition as collateral to obtain the credit necessary to fund its reorganization."[108] Congress, however, created an exception in section 552(b):

> [I]f the debtor and [a secured party] entered into a security agreement before the commencement of the case and if the security interest created by such security agreement extends to property of the debtor acquired before the commencement of the case and to proceeds, product, offspring, or profits of such property, then such security interest extends to such proceeds, products, offspring, or profits acquired by the estate after the commencement of the case to the extent provided by such security agreement and by *applicable nonbankruptcy law*, except to any extent that the court, after notice and a hearing and based on the equities of the case, orders otherwise.[109]

Before Congress amended section 552(b) as part of the Bankruptcy Reform Act of 1994, federal bankruptcy courts in Texas—and across the country—construed a mortgagee's assignment of rents to continue on post-petition rents only when the security interest was enforceable under state law—*applicable nonbankruptcy law*.[110] In fact, section 552(b) "reflects Congress' historical concern that property rights usually should be controlled by state law instead of the 'mere happenstance' of bankruptcy."[111] This meant that the mortgagee's interest deserved the same protection regardless of whether the mortgagor filed for bankruptcy.[112]

The applicable nonbankruptcy law in Texas establishes that a collateral assignment of rents is not effective "until the mortgagee obtains possession of the property, or impounds the rents, or secures the appointment

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107. 11 U.S.C. § 552(a) (1988) ("Except as provided in [section 552(b)], property acquired by the estate or by the debtor after the commencement of the case is not subject to any lien resulting from any security agreement entered into by the debtor before the commencement of the case."); *see, e.g.*, *In re* T-H New Orleans Ltd., 10 F.3d 1099, 1104 (5th Cir. 1993); *In re* Landing Assocs., Ltd., 122 B.R. 288, 294 (Bankr. W.D. Tex. 1990).

108. Freyermuth, *Modernizing Security in Rents*, *supra* note 8, at 8.

109. 11 U.S.C. § 552(b) (2004 & Supp. 2006) (emphasis added).

110. *See In re* Casbeer, 793 F.2d 1436, 1442 (5th Cir. 1986) (citing Butner v. United States, 440 U.S. 48, 55–57 (1979); *In re* Vill. Props. Ltd., 723 F.2d 441, 443 (5th Cir. 1984)).

111. *In re Vill. Props., Ltd.*, 723 F.2d at 444.

112. Randolph, *supra* note 59, at 304 (discussing the holding in Butner v. United States, 440 U.S. 48 (1979)).

of a receiver, or takes some other similar action."[113] The list of affirmative steps for proper enforcement under *Taylor v. Brennan* is not exclusive, as suggested by the final phrase: "or takes similar action."[114] Under section 552(b), therefore, if the mortgagee has properly enforced its security interest under the *Taylor* doctrine, as well as the specific loan agreement, the mortgagee retains its lien against post-petition rents.[115] In *In re Village Properties, Ltd.*, for example, the U.S. Court of Appeals for the Fifth Circuit, applying Texas law, considered whether a mortgagee holding a collateral assignment of rents was entitled to rents that had accrued after the bankruptcy petition was filed, given that the mortgagee had yet to take affirmative steps to enforce the assignment.[116] The Fifth Circuit held that the mortgagee was not entitled to post-petition rents because the assignment was "impotent" for the mortgagee's failure to obtain sequestration or take other affirmative action.[117] In dicta, however, the court contemplated that "[i]n future cases . . . federal courts may be faced with situations where a Texas mortgagee petitions for sequestration, a receiver or adequate protection but the granting of the petition is delayed or denied,"[118] and that, "[u]nder the Bankruptcy Code, however, such petitions need not be granted by a federal court for the Texas mortgagee to perfect his interest in rentals."[119] The court cited that critical language—*other similar action*—to find that merely filing a petition for receiver, regardless of outcome, is "affirmative action" of the type contemplated in the *Taylor* opinion.[120] Ironically, the Fifth Circuit eschews formalism—favored by Texas jurisprudence on assignments of rents—to posit that "[t]he form of the action required to perfect the mortgagee's interest is not as important as its substantive thrust—diligent action by the mortgagee which demonstrates that he would probably have obtained the rents had bankruptcy not intervened."[121]

Despite the above-mentioned difficulty of squaring the *Taylor* doctrine with the Bankruptcy Code, federal bankruptcy courts have allowed mortgagees to perfect a security interest in rents *after* the bankruptcy petition date. Even when a Texas mortgagee failed to take affirmative action before the filing of the mortgagor-debtor's bankruptcy petition, it perfected its collateral assignment of rents post-petition by filing a motion for relief from the stay and a motion for preliminary injunction to prohibit the debtor from using the rents (or "cash collateral").[122] Perfection

113. Taylor v. Brennan, 621 S.W.2d 592, 594 (Tex. 1981).
114. *See supra* text accompanying note 65.
115. Freyermuth, *Modernizing Security in Rents*, *supra* note 8, at 8.
116. *In re Vill. Props., Ltd*, 723 F.2d at 443.
117. *Id.* at 446.
118. *Id.*
119. *Id.*
120. *Id.*
121. *See id.*
122. *In re* Casbeer, 793 F.2d 1436, 1436 (5th Cir. 1986). This opinion has been cited with approval by the United States Supreme Court. United Sav. Ass'n of Tex. v. Timbers of Inwood Forest Assocs., 484 U.S. 367, 374 (1988).

by filing a notice with the bankruptcy court, under section 546(b) of the Bankruptcy Code, is considered by some courts to be an exception to the automatic stay and the bankruptcy trustee's avoidance powers.[123] Rather, section 546(b) of the Bankruptcy Code allows mortgagees to perfect after the filing of the bankruptcy petition by giving the debtor notice of intent to enforce the collateral assignment of rents.[124] Allowance of post-petition perfection, nevertheless, does not "relate back" to before the bankruptcy petition was filed.[125] This emphasizes the inconsistent determinations of bankruptcy courts as to the ability of lenders to reach post-petition rents.

A third and final wrinkle to the post-petition enforcement problem arises when the commercial property is occupied by a licensee rather than a tenant. A security interest in rents is governed by Texas state law requirements for the recordation of the writing in the public land records in the county where the land is located, and the enforcement and perfection of the security interest requires that the affirmative steps established in *Taylor v. Brennan* be taken. As previously mentioned, "rents" under Texas law refers to the landlord-tenant relationship, not the hotel-guest relationship.[126] R. Wilson Freyermuth, the UARA reporter, has criticized the notion that hotel room rentals are not included in the rents pledged under an assignment of rents clause.[127] Before 1994, section 552(a) operated to cut-off a lender's ability to collect "funds generated by post-petition operation of [a] hotel" as the room revenues did not constitute rents or proceeds under Texas law.[128] Nevertheless, logic strongly suggests that this construction misreads the actual intent of lenders and borrowers in commercial real estate transactions who have contracted a pledge of the project's income from which the lender expects to realize the pledged income, regardless of state law's semantic distinction between tenants and licensees.

2. *The Effect of the Bankruptcy Reform Act of 1994*

Section 214 of the Bankruptcy Reform Act amended section 552(b) of the Bankruptcy Code. The new subsection, 552(b), deals only with rents:

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123. *In re* Lake Austin Centre Joint Venture, 106 B.R. 106, 108 (Bankr. W.D. Tex. 1989) (citing *In re Casbeer*, 793 F.2d at 1443–44).

124. *In re Casbeer*, 793 F.2d at 1443; Wolters Vill., Ltd. v. Vill. Props., Ltd., 723 F.2d 441, 444 (5th Cir. 1986). *See also In re* Corpus Christi Hotel Partners, Ltd., 133 B.R. 850, 851–52 (Bankr. S.D. Tex. 1991) (in which a secured party filed a Notice of Perfection of Interest in Rents under 11 U.S.C. § 546(b)); Nat'l Real Estate Ltd. v. Consolidated Capital Prop., 104 B.R. 968, 971 (Bankr. E.D. Wisc. 1989) (same). In addition, a mortgagee's "filing a motion under 11 U.S.C. § 363 operate[s] as a Bankruptcy Code-created remedy to perfect its interests in the rents from the Property as would a notice given under 11 U.S.C. § 546(b)." *In re* Salmanson, 132 B.R. 547, 551 (Bankr. W.D. Tex. 1991).

125. *In re Casbeer*, 793 F.2d at 1443. The mortgagee would receive a "windfall" should the post-petition perfection allow collection of pre-petition rents. *Id.* (quoting *Butner*, 440 U.S. at 55). *See also In re Salmanson*, 132 B.R. at 552.

126. *See supra* text accompanying notes 66–69.

127. *See generally* Freyermuth, *Hotel Revenues, Rents, and Formalism*, *supra* note 7.

128. *In re Corpus Christi Hotel Partners, Ltd.*, 133 B.R. at 854–57.

> [I]f the debtor and [a secured party] entered into a security agreement before the commencement of the case and if the security interest created by such security agreement extends to property of the debtor acquired before commencement of the case and to amounts paid as rents of such property or the fees, charges, accounts, or other payments for the use or occupancy of rooms and other public facilities in hotels, motels, or other lodging properties, then such security interest extends to such rents and such fees, charges, accounts, or other payments acquired by the estate after the commencement of the case to the extent provided in such security agreement, except to any extent that the court, after notice and a hearing and based on the equities of the case, orders otherwise.[129]

Unlike the pre-1994 section, as well as subsection 552(b)(1), subsection 552(b)(2) does not include the problematic phrase "applicable nonbankruptcy law."[130] Mortgagees who take a lien on rents before the bankruptcy proceeding with an assignment of rents will have a valid lien on post-petition rents, despite the mortgagees' failure to perfect the security interest under applicable state mortgage law.[131]

Confusion and thus inconsistent treatment of assignment of rents in bankruptcy is a product of the courts' failure to distinguish between what the *Taylor* court described as activation of an inchoate lien (a collateral assignment of rents) and perfection of a security interest. In contrast to the notion of activation, perfection describes the method by which a lienholder puts third parties and future creditors on notice that it has a superior security interest. Section 214 of the Bankruptcy Reform Act should allow mortgagees in Texas to continue to have a valid lien on rents, pursuant to a recorded collateral assignment of rents, even when the mortgagee had failed to take affirmative steps required under Texas state law to enforce and perfect the security interest in rents.

After the 1994 amendment, legal scholars were hopeful that the new subsection 552(b)(2) created uniformity in the treatment of collateral assignments with a new "federal standard" for enforcement.[132] It seemed that Congress recognized that states' real property laws governing security interests in rents were created "without regard to the problem of postpetition perfection in bankruptcy" and thus the Code no longer mandated that "bankruptcy courts . . . shoehorn rents clauses into specific categories with state court doctrine that has not been designed for the purpose."[133] It still remains to be seen whether the 1994 changes have remedied the confusion surrounding postpetition perfection in Texas

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129. 11 U.S.C. § 552(b)(2) (1994).

130. *See id.*

131. RESTATEMENT (THIRD) OF PROP.: MORTGAGES, § 4.2, Reporter's Note, Introductory note, cmt. a (citing 140 Cong. Rec. H10752, at H10768 (1994) (statement of Rep. Brooks)).

132. R. Wilson Freyermuth, *The Circus Continues—Security Interests in Rents, Congress, the Bankruptcy Courts, and the "Rents are Subsumed in the Land" Hypothesis*, 6 J. BANKR. L. & PRAC. 115, 120–21 (1997).

133. Randolph, *supra* note 59, at 300–01.

bankruptcy courts. For example, a bankruptcy court in the Southern District of Texas recently denied a lender's objection to a Chapter 13 debtor's plan where the lender argued that it owned the rental stream and, thus, the debtor should not be allowed to use future rents for purposes of its plan.[134] The court determined that the assignment of rents provided additional security for the loan (a collateral assignment), rather than an absolute transfer of title to rents.[135] The court, in confirming the debtor's Chapter 13 plan, explained that "a creditor must 'perfect' a collateral assignment of rents before its rights can take effect," citing to *pre-1994 case law*.[136] Its failure to discuss the 1994 changes to the Code as to postpetition perfection of assignment of rents was an oversight—at best—and raises the specter that Congress has not yet solved the perfection headache. After 1994, bankruptcy courts were not supposed look to nonbankruptcy law, such as Texas mortgage law, to determine whether the creditor has a valid lien on postpetition rents. Nevertheless, the ultimate confirmation of the Chapter 13 plan would be unaffected by the 1994 changes. The court's opinion emphasized that lenders do not actually own the rental stream via an assignment of rents clause in a deed of trust, due to the fact that the lender cannot "sell the future rents because its right to them terminates when the deed of trust is canceled."[137] Perhaps more importantly, the plan provided payments to the mortgagor, made via the trustee, in excess of the monthly rents.[138] Overall, this recent case merely emphasizes the continuing uncertainty as to perfection of assignment of rents in bankruptcy.

The new subsection expressly includes hotel room revenues as rent, which overrules federal bankruptcy courts' prior rulings that held otherwise when applying Texas state property law.[139] Even though subsection 552(b)(2) "effectively mooted the classification dilemma with respect to hotels and other 'lodging properties . . . [it] did not address a wide variety of other income-generating projects."[140] Examples of income producing commercial real estate projects where the owner-mortgagor stands in a licensor-licensee relationship with the occupier include parking garages, golf courses, landfills, marinas, stadiums, student dormitories, and hotels.[141] Therefore, despite the 1994 revision of section 552, assignments of the above mentioned project revenues, as governed by Article 9, means debtors can seek refuge in bankruptcy from creditors realizing upon

134. *In re* Allen, 357 B.R. 103, 107 (Bankr. S.D. Tex. 2006).

135. *Id.* at 118.

136. *Id.* at 109 (citing *In re* Vill. Prop., Ltd., 723 F.2d 441 (5th Cir. 1984)). Additionally, the bankruptcy court cites *In re Casbeer*, 793 F.2d 1436 (5th Cir. 1986) for the proposition that a lender may perfect its collateral assignment of rents during a bankruptcy by filing a post-petition motion for preliminary injunction to prohibit the debtor from using the rents. *Id.*

137. *Id.* at 115–16.

138. *Id.* at 115.

139. *See* 11 U.S.C. § 552(b)(2) (1994).

140. Freyermuth, *Modernizing Security in Rents*, *supra* note 8, at 14.

141. *Id.* at 9–10.

pledged income that does not fall under section 552(b)(2).[142]

The reporter for the new UARA, Wilson Freyermuth, criticizes the new section 552(b)(2) on the assessment that it failed to create a uniform federal standard. Freyermuth argues that despite the legislative intent behind subsection (b)(2), the statute is poorly drafted because it fails to expressly state that the section will preempt state mortgage law.[143] He emphasizes that Congress overlooked section 544 of the Bankruptcy Code, known as the "strong-arm" statute, which allows either the bankruptcy trustee or debtor-in-possession to "avoid any security interest that a judgment creditor of personalty or a bona fide purchaser of realty could have avoided under state law as of the petition date."[144] Freyermuth's argument suggests that if a lender in Texas fails to take affirmative steps to enforce its collateral assignment of rents prior to the filing of the bankruptcy petition, the debtor can avoid post-petition enforcement by operation of section 544. Because section 552(b)(2)'s protection for rents is expressly subject to section 544's strong-arm provision, however, Freyermuth questions whether the subsection will preempt state law regarding the enforcement of an assignment of rents as attaching to hotel revenues.[145]

The UARA, which Freyermuth drafted, would resolve questions remaining as to proper interpretation of state law on the enforcement of assignments of rents in the context of bankruptcy. A statute for state and federal courts in Texas to follow would "reduce uncertainty" and "prevent a party from receiving a windfall merely by reason of the happenstance of bankruptcy."[146] The Texas legislature should adopt the UARA to simplify the law governing rental assignments and to discard "the slippery legal concepts and technical constructions of the mortgage language" now preventing mortgagees in Texas from realizing upon the pledged rentals.[147] Finally, the Act squares perfection of security interests in rents with the general procedure for perfection of security interests in personal property: recordation.

IV. THE UARA—A BETTER APPROACH FOR TEXAS

A. Creation of a Security Interest in Rents

1. Abolition of Absolute Assignment of Rents

Given the harsh consequences that result from the formalism of Texas mortgage law, sophisticated commercial mortgagees execute "absolute" assignments of rents to ensure their access to the pledged collateral. Un-

142. *Id.* at 15.
143. *Id.* at 28.
144. Restatement (Third) of Prop.: Mortgages, § 4.2 Reporter's Note, Introductory note, cmt. a.
145. *See* Freyermuth, *Modernizing Security in Rents*, *supra* note 8, at 28.
146. Restatement (Third) of Prop.: Mortgages § 4.2 Reporter's Note, Introductory note, cmt. a (quoting Butner v. United States, 440 U.S. 48, 55 (1979)).
147. Comment, *Mortgagee's Right to Rents after Default*, *supra* note 10, at 1447.

fortunately, the transfer of legal title to rents, to create a security interest, creates needless litigation. This charade is inefficient because courts must determine the actual intent of the parties. Because legalese and formalism controls, actual intent from an industry perspective might not be reflected in the loan agreement, despite the parties' best efforts. For example, if an unsophisticated entity financed a commercial real estate project, albeit rare and ill-advised, the lender is unlikely to understand the pitfalls and frustrations lurking behind a collateral assignment of rents. And because courts favor collateral assignments as a matter of policy, even sophisticated lenders' "absolute" assignments of rents are scrutinized by courts looking for language that suggests the assignment provides merely additional security for the mortgage.

The UARA, if adopted, would eliminate the distinction between a collateral and absolute assignment of rents now present in Texas. The UARA recognizes that all assignments of rents, regardless of form, are generally executed to create additional security for the mortgage debt.[148] The Act's reporter, R. Wilson Freyermuth, says that the legislation would "elevate substance over form."[149] The UARA emphasizes the reality that it should make little difference whether the assignment of rents absolutely conveys the rents or conditionally assigns the rents as additional security for the underlying mortgage debt. Fundamentally then, Texas mortgage laws' flawed characterization of an immediately effective security interest in rents as a conveyance of legal title insufficiently gives effect to borrowers' and lenders' actual intentions. Current Texas law elevates form over substance.[150] The UARA, therefore, would limit 'absolute' assignments of rents to the rare instance where a commercial real estate owner transferred legal title to rents outside the context of a mortgage loan agreement. The UARA's re-characterization of all assignments of rents as a security interest has the effect of moving the decision-making away from courts and toward the contracting parties.

2. *Security Interest in Rents Implied by Statute*

As previously stated, mortgagees almost always execute an assignment of rents clause in their mortgage documents, or by separate agreement, when financing a commercial real estate project. Commercial lenders view rents as often "the only liquid asset which [they] can reach to supplement or to avoid levying immediately upon the shrinking value that the pledged security still retains."[151] The UARA simplifies this process

148. Uniform Assignment of Rents Act (UARA) § 4(b), § 4 cmt. 3 (2005). *See also* Freyermuth, *Modernizing Security in Rents*, *supra* note 8, at 36.

149. Freyermuth, *Modernizing Security in Rents*, *supra* note 8, at 35.

150. Commentators have criticized the form over substance approach taken by Texas mortgage law. *See generally*, Forrester, *Still Crazy*, *supra* note 14, at 101; Freyermuth, *Modernizing Security in Rents*, *supra* note 8, at 29; Forrester, *Rational Approach*, *supra* note 8, at 382–83; John C. Siemers, *The Mortgagee's Lien Against Rents*, 25 TEX. TECH L. REV. 873, 892–97 (1994).

151. Comment, *Mortgagee's Right to Rents after Default*, *supra* note 10, at 1424.

with a statutory presumption that a mortgage "creates an assignment of rents arising from the real property described in the security instrument, unless the security instrument provides otherwise."[152] Given that security interests in rents are common in commercial loan agreements, the operation of UARA streamlines the loan agreement.

In residential loan agreements, however, assignments of rents are less common. The drafters of the UARA comment that the UARA will have "no systematic negative effects on residential mortgagors."[153] Usually a mortgage on a residential property finances the purchase of the borrower's primary residence and, thus, there would be no rents for the lender to collect.[154] The UARA commentary correctly posits, therefore, that the assignment of rents created by the operation of section 4(a) is irrelevant.[155]

Of course, situations arise where the borrower not only resides in the property but also rents a room to a tenant.[156] In this instance, the drafters of the Act are certain that the operation of section 4(a) still would not have any *negative* effects because non-judicial enforcement of an implied security interest in rents is not allowed under the UARA.[157] If the security interest in rents exists only by operation of the Act, the mortgagee would have to employ a judicial action for enforcement, such as an equitable receivership.[158] On the other hand, if the borrower, here renting a room to a tenant, executed a loan agreement which expressly includes an assignment of rents, then, both parties clearly contemplated enforcement.

Lastly, the UARA's statutory presumption that all enforceable security instruments create an assignment of rents arising from the real property described protects sellers under an installment land contract.[159] An installment land contract ("ILK") is a mortgage substitute that operates much like a third party loan except that the seller stands in the position of the mortgagee. Generally, the purchaser will take possession of the property at closing and agree to make monthly payments to the seller.[160] The drafters of the UARA recognize that "unsophisticated sellers" might execute a seller financing agreement without expressly taking an assignment of rents in conjunction with the financing agreement.[161] The operation of

152. UARA § 4(a).

153. UARA § 4 cmt. 1.

154. *Id.* The UARA comment to section 4 highlights the tenor of this article: assignment of rents and the problems associated therewith are generally considered in the context of commercial real estate deals.

155. *Id.*

156. *Id.*

157. UARA §§ 8(d), 9(g).

158. *See generally* UARA § 7.

159. UARA §§ 2(14)–(15) (defining "security instrument" and "security interest"), 4 cmt. 1 (explaining that an ILK fits within the Act's definitions for security instrument and security interest).

160. NELSON & WHITMAN, REAL ESTATE FINANCE, *supra* note 2, at 270–80.

161. The seller under an installment land contract "may have completed the transaction without benefit of legal counsel and thus did not appreciate the need for a separate assignment of rents." UARA § 4 cmt. 1.

section 4(a) will adequately protect the seller-financer.

3. Public Policy Considerations

In 1981, the Texas Supreme Court limited lenders' access to rents because mortgagors retain possession and control of the mortgaged property until foreclosure under lien theory rules. The ability of lenders to collect rents under a security agreement was contrary, therefore, to the basic mortgage law rules of the state. Also, the court questioned whether a lender would apply rents to the mortgage debt if the loan agreement, as typically drafted, did not affirmatively articulate this duty.

In contrast, the drafters of the 2005 UARA do not trust financially distressed mortgagors to apply rents to the mortgage debt. Owners of commercial real estate probably lost favor with the courts during the market crash in the 1980s. The overdevelopment and subsequent collapse of the real estate market in Texas and across the country ruined businesses and depressed real property values. In turn, the income stream of commercial real estate projects dwindled; financially distressed mortgagors were guilty of milking rents while in default on their mortgage loans.[162] As a general observation, the fear that absolute assignments provide no assurance that the lender will apply collected rents to the mortgage debt is likely irrelevant in the event of default as the borrower is in arrears and, more likely than not, the mortgagee would apply rents to the existing debt.[163]

The drafters of the UARA, and the reporter, Freyermuth, in particular, favor having a uniform, comprehensive, and national statute that governs all aspects of assignments of rents, as would be the case if security interests in real property were subject to Article 9 of the U.C.C.[164] Without a legislative response, commercial lenders and borrowers suffer from uncertainty in enforcement of an important matter in their loan agreements—the collection and disbursement of rentals.[165] In Texas, the Act would all but eliminate litigation concerning the present semantics of collateral and absolute assignments of rents, but in a practical sense, a nationally recognized rule benefits Texas lenders. Given that commercial real estate projects might take Texas entities to other parts of the country, a uniform assignment of rents law would be greatly beneficial.

B. Enforcement Methods Adopted Under the UARA

Section 6 of the UARA, if adopted, would provide Texas mortgagees a statutory entitlement for enforcement of assignments of rents against all subsequent accruing rents until foreclosure.[166] In addition, sections 7, 8,

162. *See generally* Sandra Elzerman, *Interests in Collaterally Assigned Rents and Profits under the Bankruptcy Code*, 22 Hous. L. Rev. 1251, 1251 (1985).
163. *See* Comment, *Mortgagee's Right to Rents after Default*, *supra* note 10, at 1427.
164. *See* Freyermuth, *Modernizing Security in Rents*, *supra* note 8, at 4.
165. *Id.* at 2–3.
166. *See* UARA § 6.

and 9 of the Act enumerate remedial methods for enforcement while specifying that such measures are in no way a mortgagee's sole and exclusive remedies.[167] In fact, the UARA permits enforcement of security interests in rents by any additional method recognized by Texas state law.[168] For example, the UARA allows a mortgagee to enforce an assignment of rents by obtaining possession of the underlying property pursuant to Texas state law;[169] the Act does not eliminate, however, the mortgagee's responsibilities and liabilities to tenants and third parties.[170] Conversely, the UARA states that enforcement of an assignment of rents under one of the "methods identified in Sections 7, 8, and 9 . . . does not make the assignee a mortgagee in possession of the real property."[171]

1. Enforcement by Notification

The UARA empowers a mortgagee to enforce its assignment of rents by notification to either the mortgagor[172] or tenants.[173] In fact, the Act provides a form in section 10 that "when properly completed, is sufficient to satisfy the requirements of section 9."[174] While Texas lenders currently enforce absolute assignments by sending notifications to the mortgagor or tenants, the Act's elimination of the formalistic distinctions between a collateral and absolute assignment provides enforcement by notification as a possible remedy for all mortgagees of commercial real estate.[175] Of significant interest to commercial mortgagees in Texas is the fact that rents collected by notification to either the mortgagor or tenant do not necessarily need to be applied to "the payment of expenses of protecting or maintaining the real property" unless the assignment agreement indicates otherwise.[176]

Notwithstanding the fact that section 4(a) of the UARA implies an assignment of rents in all mortgage agreements, a mortgagee cannot enforce its security interests in rents by notification when the mortgagor occupies the property as his primary residence.[177] Therefore, even if the mortgagor leases a room to a tenant, he is still not subject to the mortgagee's enforcement powers under section 9 of the UARA if he too occupies the property.[178]

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167. UARA § 6(a) cmt.1.
168. *See id.*
169. *See* Taylor v. Brennan, 621 S.W.2d 592, 594 (Tex. 1981).
170. UARA § 6 cmt. 1.
171. UARA § 11(1).
172. UARA § 8.
173. UARA § 9.
174. UARA § 10.
175. *See generally* UARA §§ 8(d), 9(g).
176. UARA § 13(a).
177. UARA § 8 cmt. 4.
178. UARA § 9 cmt. 7.

2. Appointment of Receiver

The UARA would provide Texas lenders more certainty that they may obtain the appointment of a receiver to enforce their assignment of rents in the event of the mortgagor's default. Adoption of UARA section 7(a)(1)(A) would eliminate Texas courts' current equitable discretion whether to enforce a receivership clause recited in the loan agreement.[179] Rather, the UARA "takes the position that a receivership clause is enforceable following the [mortgagor's] default."[180] Under section 7, a Texas mortgagee may obtain its right to equitable receivership to enforce its security interest in rents regardless of whether the receivership clause is recited in the assignment of rents agreement or elsewhere in the loan documents.[181] The UARA sets forth clear standards for when a mortgagee is entitled to a receiver. To obtain its equitable right to a receiver in the event of a mortgagor's default, the mortgagee must prove one of the following: the loan agreement contains a receivership clause, the mortgaged property is insufficient to satisfy the debt, the mortgagor is failing to give rents to the mortgagee in violation of a provision of the UARA, or a junior mortgagee has already diligently obtained a receiver.[182]

The priority rule provided by UARA section 7 agrees with the current Texas law. If a junior mortgagee obtains appointment of a receiver to enforce a lien on the rents, pursuant to an assignment of rents agreement, a senior mortgagee is allowed to intervene and enforce its superior interest.[183] The senior mortgagee is only allowed, however, to collect rents accruing after its intervention.[184] The junior mortgagee in Texas will continue to be rewarded for "superior diligence" in "obtaining the appointment of a receiver for [its] benefit alone" if the UARA is adopted.[185]

Under current law, Texas courts are allowed to appoint a receiver *ex parte* in extraordinary circumstances. A mortgagee seeking appointment without notice to the mortgagor must demonstrate to the court that a "great emergency or imperative necessity" requires this equitable relief.[186] The drafters of the UARA allow state law to determine when, if ever, the ex parte appointment of a receiver is allowed.[187] For example, in Texas civil courts in Dallas County, to carry its burden, a mortgagee must show that "irreparable harm is imminent and there is insufficient time to notify the opposing party or counsel."[188]

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179. *See supra* text accompanying notes 79.
180. UARA § 7 cmt. 4.
181. *See id.*
182. UARA § 7
183. Wood v. Fetzer, 19 S.W.2d 1113, 1114 (Tex. Civ. App.—Waco 1929, writ ref'd).
184. *Id.*
185. *See id.*
186. Best Inv. Co. v. Whirley, 536 S.W.2d 578, 581 (Tex. Civ. App.—Dallas 1976, no writ) (citing Solomon v. Matthews, 238 S.W. 307 (Tex. Civ. App.—Amarillo 1922, no writ) for the proposition that appointment of ex parte receivers is to be made only in exceptional and extreme situations).
187. UARA § 7 cmt. 7.
188. Dallas (Tex.) Civ. Dist. Ct. Loc. R. 2.02(b)(1).

3. Waste of Rents and UARA

Citing *Taylor v. Brennan* with approval, the drafters of the UARA agree that a lender may bring an action for damages for waste against a mortgagor that pockets the rents after a properly enforced assignment of rents. As stated in Part(II)(A)(5) above, the Texas Supreme Court recognizes a mortgagee's action for waste when a mortgagor milks the rents, so long as the mortgagee has taken the requisite affirmative steps to enforce its security interest in the rentals.[189] The *Taylor* holding was contingent upon the finding that rents are a separate security from the underlying real property, so damages are measured as the amount of rents collected after default but not applied to the mortgage debt.[190] Generally, a mortgagee may only bring a suit for waste against the mortgagor if the damaged property is no longer sufficient security for the debt.[191]

The UARA agrees with the *Taylor* opinion and the Texas Supreme Court on the issue of the rents being a "distinct source of collateral."[192] The drafters of the Act refused to follow the jurisdictions which hold that postpetition rents are "'subsumed' within the valuation of the real property itself." Rather, under the UARA, like Texas, "rents accruing prior to the completion of a foreclosure constitute a source of collateral that is distinct from the real property from which those rents accrued."[193]

The Act, however, diverges from the *Taylor v. Brennan* doctrine in that a lender's remedies enumerated under the Act provide clear and simple standards of enforcement. Under the Act, a lender may enforce what Texas considers to be a collateral assignment of rents by mailing notices to either the borrower or the borrower's tenants. Should the borrower fail to remit rents, the lender's claim for waste of rents is actionable regardless of the fact that Texas property law characterizes collateral assignments as inchoate liens.

4. Protection of Tenants and the UARA

The Texas legislature should adopt the UARA because it provides statutory guidelines for enforcement of assignments of rents and protects the expectations of tenants, which are affected by lenders' actions. For example, even though section 9 of the UARA provides mortgagees with a remedy of enforcement by notifying tenants, the drafters carefully qualify this right by incorporating express rights to tenants. First, a mortgagee's enforcement of an assignment of rents by notification directly to a tenant is

189. Taylor v. Brennan, 621 S.W.2d 592, 593–94 (Tex. 1981).
190. Heath, *supra* note 77, at 826.
191. Frio Inv., Inc. v. 4m-IRC/Rohde, 705 S.W.2d 784, 786 (Tex. App.—San Antonio 1986, writ ref'd n.r.e.). The Fort Worth Court of Appeals pronounced that "a mortgagee is entitled to the amount of the diminution of his security, and not necessarily the amount of damage done to the property; because, where his security is still sufficient or his debt finally paid, he is not damaged." Wheeler v. Peterson, 331 S.W.2d 81, 83 (Tex. Civ. App.—Ft. Worth 1960, writ dism'd).
192. *See* UARA § 4(b), cmt. 2.
193. UARA § 4 cmt. 2.

subject to claims or defenses a tenant has under Texas law.[194] This provision contemplates, for example, that a tenant may refuse to pay rent if the owner-mortgagor has failed to comply with an express provision in the lease, such as a maintenance request. Second, the drafters anticipated a situation where both a senior and junior mortgagee might attempt to enforce its respective assignment of rents.[195] Given that there are two assignees, the Act protects the tenant from liability. If a tenant receives a notification from a mortgagee to pay rents directly to it, the tenant is not required to later pay a subsequent mortgagee that makes a request for rents; instead, the tenant is allowed to continue paying the first mortgagee, in accordance with the notification first received, until that prior notification is properly cancelled.[196] In fact, the Act protects tenants against notifications sent in error. Should a tenant pay a mortgagee, the mortgagor cannot hold the tenant liable for breach of its lease.[197] Lastly, the UARA reasonably provides tenants time to consider the effect of a notification they receive from a mortgagee attempting to enforce an assignment of rents.[198] Such a grace period gives tenants the opportunity to speak with the owner-mortgagor, mortgagee, or their attorney.

Under section 13(a), if a mortgagee enforces its security interest in rents by notification to either the mortgagor or tenant, it does not need to apply those rents to the maintenance and operation of the real property. Ever cognizant of tenants' rights, drafters of the UARA were aware that failure to maintain the property may have negative effects on tenants. Therefore, section 13(c) provides:

> This [act] does not limit the standing or right of a tenant to request a court to appoint a receiver for the real property subject to the assignment or to seek other relief on the ground that the assignee's nonpayment of expenses of protecting or maintaining the real property has caused or threatened harm to the tenant's interest in the property. Whether the tenant is entitled to the appointment of a receiver or other relief is governed by law of this state other than this [act].[199]

In general, the drafters gave consideration that tenants' rights may be affected by an assignment of rents notwithstanding that they are not parties to the agreement.

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194. *See* UARA § 9(c).
195. UARA § 9(e).
196. UARA § 9(c)(3)–(4), (e)–(f).
197. UARA § 9(c)(3).
198. The Act provides that after tenant has "received a notification under [§ 9](a) is not in default for nonpayment of rents accruing within 30 days after the date the notification is received before the earlier of: (1) 10 days after the date the next regularly scheduled rental payment would be due; or (2) 30 days after the date the tenant receives the notification." UARA § 9(d).
199. UARA § 13(c).

C. UARA—Perfecting Perfection

The UARA sets clear standards for the perfection of assignments of rents. The Act "remove[s] any lingering question regarding the enforceability of a recorded assignment of rents" after the 1994 amendment to section 552(b)(2).[200] Section 5(b) of the UARA, if adopted, would overrule the applicability of the *Taylor v. Brennan* doctrine to the postpetition perfection of a security interest in rents as Congress thought it had already accomplished in 1994. The Act clearly distinguishes between perfection of a security interest in rents, on the one hand, and enforcement on the other.[201] Section 5(b) of the Act provides that a security interest in rents is perfected upon the recordation of the writing pursuant to the state's recording statute notwithstanding the fact that the assignment may be subject to conditions precedent, such as default, before the mortgagee may enforce it.[202]

Smoothing out the additional wrinkle in the perfection dilemma of what constitutes rents, the Act expressly defines the term as it operates within the text of the Act.[203] As previously explained, not all project revenues are derived from a landlord-tenant relationship. But under current Texas law, the fees paid by a licensee to a licensor do not constitute rents. Remember that under Texas property law, hotel room rentals do no constitute rent. The Bankruptcy Reform Act of 1994 expressly addressed the issue of hotel revenues by incorporating such rentals into the security interest in rents. Nevertheless, Texas law governing the proper characterization of rents still governs whether an assignment of rents may reach post-petition revenue from entities such as a healthcare facility or parking garage. The UARA provides six illustrations to address what revenues constitute "rents" under the definition in section 2(12).[204] In addition to the regular landlord-tenant relationship, hotel room revenues would also be rents under the Act.[205] The drafters point out that revenue from services such as the room service, however, would not constitute rent, as it is not related to the lodger's right to occupy the room.[206] Lastly, the Act, by illustration, includes in its conception of rents fees paid by a nursing home resident, marina fees, and parking garage fees.[207]

As a sidelight, other problem areas exist in the context of bankruptcy, given the nature of assignment of rents, but are outside the scope of this Comment. For instance, creditors, both secured and unsecured, would attempt to reach the debtor's estate in order to realize part, if not all, of their respective debts. The UARA offers rules of priority for competing mortgagees each holding an assignment of rents as well as disputes

200. Freyermuth, *Modernizing Security in Rents*, *supra* note 8, at 29.
201. *See supra* pt. III(B)(2).
202. UARA § 5(b).
203. UARA § 2(12).
204. UARA § 2 cmt. 12.
205. UARA § 2 cmt. 12 illus. 2.
206. *Id.*
207. UARA § 2 cmt. 12 illust. 3, 4, 5.

among mortgagees and secured creditors.[208]

IV. CONCLUSION

During the initial stages of drafting, the Act was referred to as the Uniform Mortgagee Access to Rents Act.[209] Commercial lenders' access to rents is important because the rental stream is a distinct and separate source of collateral to secure the mortgage obligation. Progressive states, such as California, have passed statutes that require only recordation for perfection of an assignment of rents; such statutes break with the common law rule now in effect in Texas.[210] The new UARA is a well-drafted model law that creates a statutory lien on rents that is perfected once a mortgagee executes and records its deed of trust.[211] If adopted by Texas, the Act would simplify state mortgage law and discard the burdensome common law requirements adopted under *Taylor v. Brennan.* Because perfection is a crucial issue after the mortgagor files for bankruptcy, the UARA simplifies perfection and, therefore, limits trustees' (or debtors in possession) ability to avoid a pre-petition lien on rents. Above all, Texas should adopt the UARA because it emphasizes that any distinction between a collateral and absolute assignment is more semantic than real. The Act should be adopted if only to eliminate the formalistic rules that now require mortgagors to "convey" legal title to rents to lenders in order to create an immediately enforceable security interest in rents.

208. *See, e.g.*, UARA §§ 5(c), 15(b)–(d); Freyermuth, *Modernizing Security in Rents*, *supra* note 8, at 57–62; Debra J. Schnebel, *Intercreditor and Subordination Agreements—A Practical Guide*, 118 BANKING L.J. 48, 50–53, 59–62 (2001). Section 510(a) of the Bankruptcy Code mandates that bankruptcy courts enforce intercreditor agreements to the extent they would be enforceable contracts under state law. Schnebel, *supra* note 208, at 48.

209. Memorandum from Edward F. Lowry, Jr., *supra* note 13 (subject matter contained in heading).

210. *See* CAL. CIV. CODE § 2938(a)–(b) (West 2006).

211. *See* UARA § 4(a). In 2007, the Uniform Assignment of Rents Act (2005) was introduced by senate bill in two states—Connecticut and Idaho. S.B. 597, Gen. Assem., Jan. Sess. (Conn. 2007) (sponsored by Sen. Jonathan A. Harris, 5th Dist., and referred to the Joint Committee on Judiciary); S.B. 1013, 59th Leg., Reg. Sess. (Idaho 2007) (passed Feb. 1, 2007 and introduced to the House February 2, 2007).